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DEVELOPING COUNTRIES

Switching Some Multilateral Loans to Grants Lessens Poor Country Debt Burdens

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Abstract
In July 2001, President Bush proposed that the World Bank and other development banks dramatically increase the distribution of grants to the worlds poorest countries, recommending that grants replace up to 50 percent of future lending. This proposal was motivated, in part, by concerns regarding poor countries long-term debt burdens and the adequacy of recent initiatives to provide debt relief for the worlds poorest countries. The presidents grants proposal would mean a significant change for multilateral institutions such as the World Bank, which traditionally use low-cost loans to deliver development assistance. The proposal has been controversial, in part due to concerns about the impact of the proposal on the amount of resources that will be available for poor countries. The World Bank estimates that the presidents proposal could reduce its resources by about $100 billion over the next 40 years.1

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GAO Accountability★Integrity★Reliability

Highlights

DEVELOPING COUNTRIES
Switching Some Multilateral Loans to Grants Lessens Poor Country Debt Burdens

Highlights of GAO-02-593, a report to the Ranking Minority Member of the Senate Foreign Relations Committee and the Chairman of the House Subcommittee on International Monetary Policy and Trade, Committee on Financial Services.

Why GAO Did This Study

Under current debt relief efforts, the World Bank and International Monetary Fund project that all countries will become debt sustainable (with a debt-to-export ratio near or below 150 percent) in 20 years. However, GAO and others have questioned whether current debt relief efforts will provide sufficient relief. In July 2001, President Bush proposed that the World Bank and other multilateral development banks replace up to 50 percent of future lending to the world's poorest countries with grants. This proposal was motivated, in part, by concerns about poor countries' long-term debt burdens. The World Bank has estimated that the cost of the 50-percent grants proposal would reach $100 billion over the next 40 years. GAO (1) assessed the effect of the loans-to-grants proposal on 10 poor countries' ability to repay their debt, and (2) estimated the loss in revenue that the World Bank would incur from the grants proposal.

What GAO Found

A shift from loans to grants would lessen poor countries' debt burdens, increasing their ability to repay future debt. The World Bank and International Monetary Fund projections assume that poor countries' future export growth rates will be approximately double historical rates. As a result, they project that all 10 countries GAO analyzed will be debt sustainable under current debt relief efforts (see column 2). GAO believes such high export growth rates are unlikely due to these countries' reliance on volatile primary commodities and the impact of HIV/AIDS. Using historical export growth rates, GAO found that, under the current debt relief efforts, only 2 of the 10 countries it analyzed would be debt sustainable over the next 20 years (see column 3). However, if grants were to replace 50 percent of future multilateral loans, 4 of the 10 countries analyzed would be debt sustainable for 20 years and 2 other countries would be debt sustainable for most of the period (see column 4). GAO also found that 50-percent grants would promote debt sustainability better than 100-percent debt forgiveness of old multilateral debt (see column 5).

GAO estimates that the financial loss of the 50-percent grants proposal is $15.6 billion in present value terms. The World Bank estimated the financial loss of the proposal would reach $100 billion in nominal dollars over 40 years. However, the World Bank's estimate does not include the impact of inflation and the investment income that is expected to accrue over time. Furthermore, GAO found that if donor contributions to the World Bank were to increase by 1.6 percent a year, which is less than the expected rate of inflation over the next 40 years, the World Bank could fully finance the 50-percent grants proposal.

The Department of the Treasury agreed with the report's findings.

Projected 20-Year Debt-to-Export Ratios under Four Scenarios (percent)

Country	World Bank/IMF projections - current debt relief efforts	Assuming historical export growth rates		
		Current debt relief efforts	50-percent grant proposal	Full forgiveness of old multilateral debt
Benin	59	168	99	142
Bolivia	153	668	393	649
Burkina-Faso	114	713	377	648
Ethiopia	79	572	328	502
Mali	101	62	42	44
Mozambique	48	153	78	140
Nicaragua	60	377	210	358
Tanzania	132	434	239	429
Uganda	32	339	125	324
Zambia	101	837	457	784
Average	**88**	**432**	**235**	**402**

Note: According to the World Bank and International Monetary Fund, countries are projected to be debt sustainable if their debt-to-export ratio is near or below 150 percent. The 10 countries chosen will receive about two-thirds of debt relief under current efforts.

This is a test for developing highlights for a GAO report. The full report, including GAO's objectives, scope, methodology, and analysis is available at www.gao.gov/cgi-bin/ getrpt?GAO-02-593. For additional information about the report, contact Joseph A. Christoff at (202) 512-8979. To provide comments on this test highlights, contact Keith Fultz (202-512-3200) or e-mail HighlightsTest@gao.gov.

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Abbreviations

DSA	debt sustainability analysis
FY	fiscal year
GDP	gross domestic project
HIPC	Heavily Indebted Poor Country
HIV/AIDS	Human Immunodeficiency Virus/Acquired Immunodeficiency Syndrome
IBRD	International Bank for Reconstruction and Development
IDA	International Development Agency
IMF	International Monetary Fund
UNAIDS	Joint United Nations Programme on HIV/AIDS

GAO
Accountability * Integrity * Reliability

United States General Accounting Office
Washington, D.C. 20548

April 19, 2002

The Honorable Jesse Helms
Ranking Minority Member, Committee on Foreign Relations
United States Senate

The Honorable Douglas Bereuter
Chairman, Subcommittee on International Monetary Policy and Trade
Committee on Financial Services
House of Representatives

In July 2001, President Bush proposed that the World Bank and other development banks dramatically increase the distribution of grants to the world's poorest countries, recommending that grants replace up to 50 percent of future lending. This proposal was motivated, in part, by concerns regarding poor countries' long-term debt burdens and the adequacy of recent initiatives to provide debt relief for the world's poorest countries. The president's grants proposal would mean a significant change for multilateral institutions such as the World Bank, which traditionally use low-cost loans to deliver development assistance. The proposal has been controversial, in part due to concerns about the impact of the proposal on the amount of resources that will be available for poor countries. The World Bank estimates that the president's proposal could reduce its resources by about $100 billion over the next 40 years.[1]

Recognizing that previous assistance efforts have not resolved the debt problems of poor countries, you asked us to review the proposal to shift a portion of multilateral institutions' loans to grants. In response, we assessed (1) how the loans-to-grants proposal would affect poor countries' ability to repay their debt, (2) how it would affect the resources available to the World Bank for poor countries, and (3) how our projections for countries' debt sustainability[2] and the financial loss to the World Bank from

[1]The World Bank reports in *Grants in IDA13, Summarizing the Options* (March 2002) that the 50-percent grants proposal would result in $59 billion in lost repayments over 40 years. This $59 billion loss in debt repayments would result in an additional $41 billion loss in investment income to the World Bank.

[2]The World Bank and International Monetary Fund consider a country to be "debt sustainable" if the ratio of a country's debt (in present value terms) to the value of its exports is 150 percent or less, which they believe allows countries to make their future debt payments on time and without further debt relief.

the grants proposal compare with World Bank and International Monetary Fund (IMF) estimates.

In conducting our analyses, we built on prior work that examined World Bank and IMF 20-year projections on poor countries' debt burdens. The World Bank and the IMF reviewed and provided detailed comments on this earlier analysis. We also used World Bank and IMF analyses that included detailed country-specific economic forecasts and projections of the financial implications of switching from loans to grants. However, we were unable to discuss our new findings with World Bank and IMF officials because the Department of the Treasury did not approve our access to officials of those institutions.[3] Treasury officials denied our requests for access to officials of the multilateral institutions because they were concerned that our engagement would interfere with ongoing negotiations to refinance the World Bank's International Development Agency. (See app. I for an expanded discussion of our scope and methodology.)

Results in Brief

A shift of multilateral loans to grants would lessen poor countries' debt burdens, increasing their ability to repay future debt. If grants were to replace 50 percent of future multilateral loans (assuming historical export growth rates), 4 of the 10 countries analyzed would be debt sustainable for 20 years and 2 other countries would be debt sustainable for most of the 20 years. However, the 4 remaining countries analyzed would not become debt sustainable even if grants replace 50 percent of their future multilateral loans. Furthermore, the grants proposal is more effective in promoting debt sustainability than proposals to forgive old multilateral debt.

The total financial loss to the World Bank of a 50-percent shift from loans to grants over the next 40 years would be $15.6 billion in present value terms. The options for making up the foregone revenue from the 50-percent grants proposal are fairly limited. Financing the president's proposal through harder terms on the remaining loans to poor countries would reduce and potentially nullify any improvement to their debt sustainability arising from the 50-percent grants proposal. However, if donor contributions to the World Bank were to increase by 1.6 percent a year, which is less than the

[3]The articles of agreement for the World Bank and the IMF require the United States to deal with these organizations only through the Department of the Treasury.

projected rate of inflation over the next 40 years, the World Bank could fully finance the 50-percent grants proposal.

GAO's projections on poor countries' future debt sustainability and the financial loss to the World Bank of the 50-percent grants proposal differ substantially from World Bank and IMF projections. First, the World Bank and IMF project that all 10 countries will attain debt sustainability under the current debt relief initiative by assuming that the countries' future export growth rates will greatly exceed those achieved in the past. However, high export growth rates are unlikely because these countries rely on primary commodities, such as coffee and cotton, for a significant proportion of their export revenue; since 1995, the prices of these commodities have moved in a downward trend. In addition, HIV/AIDS is expected to reduce the overall productivity of these countries. Second, GAO characterizes the financial loss of the 50-percent grants proposal differently than the World Bank. While the World Bank estimates that the financial loss from the proposal would reach $100 billion in nominal dollars over 40 years, its methodology assumes that the value of a dollar received today is worth the same as a dollar received 40 years from now. However, after including the expected impact of inflation and the investment income that could accrue over time, GAO estimates the financial loss of the grants proposal to the World Bank is only $15.6 billion in present value terms.

GAO provided a copy of the draft report to the Department of the Treasury for review and comment. Treasury agreed with the report's findings.

Background

The World Bank and the IMF have classified 42 countries as heavily indebted and poor; three quarters of these are in sub-Saharan Africa. Most of these countries receive substantial amounts of development assistance from governments, multilateral organizations, and nongovernmental organizations. During the 1970s and 1980s, many low-income countries sharply increased their external borrowing, mostly from other governments or multilateral institutions. During this period, the price of primary commodities tended to be high, contributing to optimistic export growth projections on the part of developing countries, which encouraged them to overborrow. By the end of 1997, the total external debt of these 42 countries had a face value of more than $200 billion. Much of this debt was not being repaid or was repaid only with the support of donors.

In 1996, creditors agreed to create the Heavily Indebted Poor Countries (HIPC) initiative to address concerns that some poor countries would have debt burdens greater than their ability to pay, despite debt relief from bilateral creditors.[4] In 1999, in response to concerns about the continuing vulnerability of these countries, the World Bank and the IMF agreed to enhance the HIPC initiative, which more than doubled the estimated amount of debt relief to over $28 billion for 32 countries. Under the enhanced HIPC initiative, countries seeking debt relief must first carry out economic and social reforms under specified programs, at which point their eligibility is assessed at what is called the "decision point." The World Bank and IMF then determine what assistance is required to achieve the country's debt sustainability. The World Bank and IMF prepare detailed economic analyses for this purpose, including economic projections covering 20 years. To date, 27 poor countries have reached their decision points.

In June 2000, GAO reported that, although the enhanced HIPC initiative will provide significant debt relief to recipient countries, the initiative alone is not likely to provide recipients with lasting relief from their debt problems unless they achieve strong, sustained economic growth.[5] GAO's analysis indicated that World Bank and IMF assumptions about the growth of countries' export earnings may be optimistic for a variety of reasons, and failure to achieve the projected levels of growth could lead to recurring difficulties in repaying debt.

[4]Efforts to relieve the debt burdens of poor countries have concentrated on the external debt of these countries. Thus, debt sustainability is defined in terms of repaying debt owed to external creditors, with export earnings considered an important source of revenue for repaying this debt.

[5]See United States General Accounting Office, *Developing Countries: Debt Relief Initiative for Poor Countries Faces Challenges*, GAO/NSIAD-00-161 (Washington, D.C.: June 29, 2000).

Shifting Loans to Grants Would Have a Positive Impact on Debt Sustainability for Poor Countries

A shift from loans to grants would benefit all countries' ability to repay their future debt. However, we found that a shift to grants across all the multilateral institutions would help some, though not all, of the 10 countries we analyzed to become debt sustainable. Under the 50-percent grants proposal, 4 of the 10 countries would be debt sustainable under their historical growth rates over the 20-year projection period,[6] and 2 would be debt sustainable for most of this period. However, the 4 remaining countries we analyzed would not achieve debt sustainability at historical export growth rates. We also found that the 50-percent grants proposal would promote greater opportunity to achieve debt sustainability than 100-percent debt forgiveness on old multilateral debt. (See app. II for an explanation of the assumptions used for these findings.)

Grants Can Help Some Countries Reach Debt Sustainability

According to the World Bank and IMF, countries are debt sustainable when the present value of their future debt divided by their future exports is below 150 percent. As shown in table 1, under the current debt relief initiative, but assuming the historical export growth rates of each country, only Mali and Mozambique are projected to be at or near debt sustainable thresholds in the future, with most countries' debt-to-export ratios substantially above those thresholds. However, if 50 percent of the projected lending from multilateral institutions to these 10 countries were to be provided by grants, then 2 additional countries—Benin and Uganda—would become debt sustainable over the 20-year period. In addition, although they are considered unsustainable at the 20-year point, two other countries, Nicaragua and Tanzania, are either debt sustainable or nearly so for a considerable portion of the 20-year period.

[6]Our analysis of debt sustainability differs from the World Bank and IMF analysis in that we assume future export growth will be similar to historical levels, whereas the World Bank and IMF assume that future export growth rates will average more than double historical levels. We discuss this issue in greater detail later in the report.

Table 1: Projected 20-Year Debt-to-Export Ratios under Three Scenarios

Country	Historical baseline (percent)	Impact of grants proposal (percent)	Impact of full forgiveness of old multilateral debt (percent)
Benin	168	*99*	*142*
Bolivia[a]	668	393	649
Burkina-Faso	713	377	648
Ethiopia	572	328	502
Mali	*62*	*42*	*44*
Mozambique	*153*	*78*	*140*
Nicaragua	377	210	358
Tanzania	434	239	429
Uganda	339	*125*	324
Zambia	837	457	784
Average	**432**	**235**	**402**

[a]Bolivia is considered eligible for both concessional and nonconcessional resources from the World Bank. As such, it may not be eligible for grants.

Note: Countries projected to be debt sustainable are in italics. That is, their debt-to-export ratio is near or below 150 percent.

GAO's projections of debt sustainability assume countries received debt relief under the enhanced HIPC initiative and grow at historical export growth rates. In addition, we assume that countries receive additional bilateral and multilateral assistance to replace foreign exchange shortfalls due to lower export earnings.

Source: GAO analysis.

The 50-percent grants proposal has beneficial effects on the debt-to-export ratios of all 10 countries we analyzed. Their debt-to-export ratios are projected to decline from an average of 432 percent under the historical baseline to an average 235 percent if they were to receive 50-percent of their future multilateral lending in the form of grants. However, the 50-percent grants proposal does not help every country become debt sustainable over the 20-year projection period. Based on our analysis, Bolivia, Burkina-Faso, Ethiopia, and Zambia will not be debt sustainable at the end of the 20-year period, even if they receive 50 percent of their future assistance from multilateral institutions in the form of grants. The benefits from 50-percent grants are not sufficient to achieve debt sustainability because these 4 countries are projected to borrow a substantial amount of additional resources in the future to help compensate for the insufficient export revenue generated under historical growth rates.

In addition, we found that if the grants proposal were increased to an average of about 67 percent for the 10 countries analyzed, all would become debt sustainable by the end of the 20-year period. As table 2 shows, Bolivia would require the greatest proportion of grants, needing 90.8 percent of its future multilateral assistance in the form of grants to achieve debt sustainability.

Table 2: Required Multilateral Grants as a Share of Multilateral Assistance to Achieve Debt Sustainability

Country	Required multilateral grant level (percent)
Benin	11.1
Bolivia	90.8
Burkina-Faso	79.7
Ethiopia	79.3
Mali	0
Mozambique	1.3
Nicaragua	61.2
Tanzania	68.7
Uganda	38.3
Zambia	83.7
Average	**67.2**[a]

[a]Weighted average.

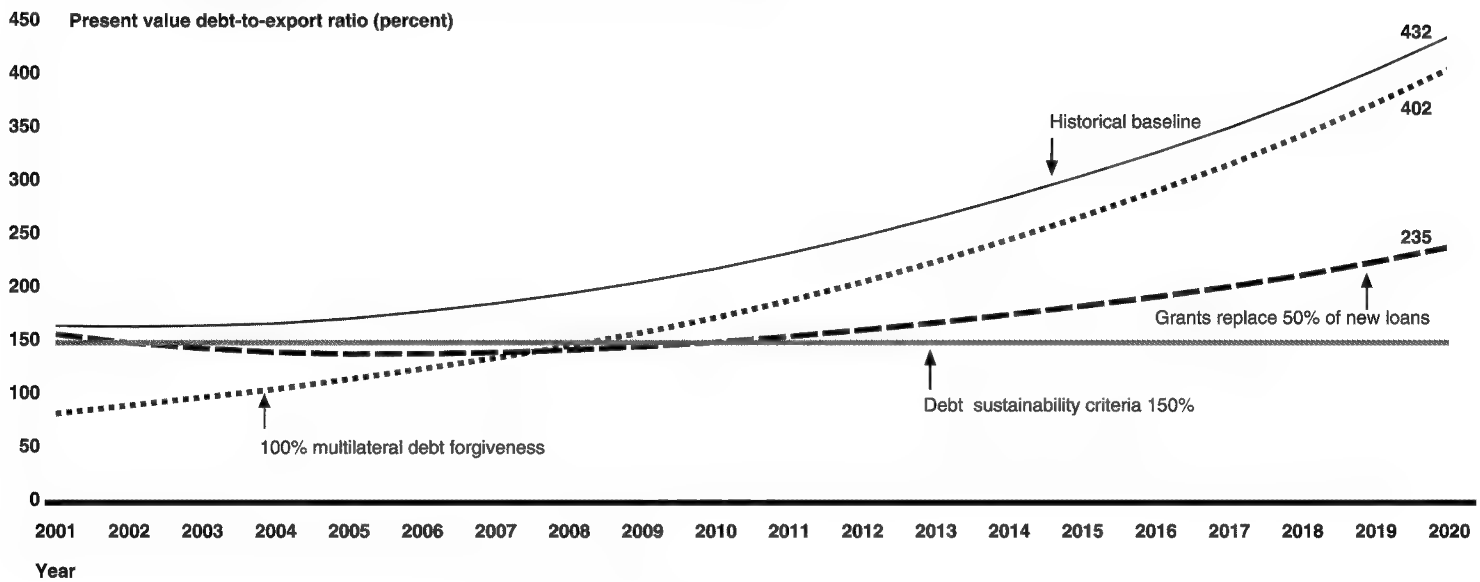
Source: GAO analysis.

Grants Proposal Contributes More to Debt Sustainability Than Full Forgiveness of Old Multilateral Debt

The grants proposal is also more effective in promoting debt sustainability than proposals to forgive old multilateral debt, as shown in table 1. Many nongovernmental organizations and debt relief advocates have recommended that multilateral organizations follow the course taken by some countries and forgive 100 percent of the old debt owed by poor nations. However, our analysis shows that the debt ratios are considerably higher under the 100-percent debt forgiveness scenario than under the grants proposal. While 100-percent forgiveness of existing multilateral debt would dramatically improve countries' debt ratios immediately following forgiveness, the advantage of this plan over the 50-percent grants proposal is eliminated after 7 years (see fig. 1). This is because, following HIPC debt relief, countries are projected to accumulate a substantial

amount of new debt that will quickly become unsustainable. The 50-percent grants proposal mitigates half of the impact of this new debt as it accumulates.

Figure 1: 20-Year Debt Sustainability Projections for 10 Poor Countries



Note: The lines for the three scenarios represent the annual average debt ratios for the 10 countries.

Source: GAO analysis.

Grants Proposal Can Be Financed through Relatively Small Increases in Donor Contributions

President Bush's proposal to shift 50 percent of multilateral loans to grants would reduce the amount of future resources available to the World Bank, but donor countries could finance this deficit with relatively small increases in their contributions. We estimate that it would require $9.7 billion in present value terms to replace the World Bank's projected lost revenue over the next 40 years. This amount represents about 8 percent of the $120.2 billion in present value terms that the World Bank expects to disburse to poor countries over this 40-year time frame. Efforts to eliminate this shortfall by levying harder loan terms on poor countries are impractical, given their already difficult debt burdens. However, donors could fully finance the 50-percent grants proposal if they increase their

contribution to the World Bank's International Development Association (IDA)[7] by 1.6 percent each year—less than the expected rate of inflation. (See app. III for an explanation of the assumptions used for these findings.)

Shift to 50-Percent Grants Would Reduce World Bank Concessional Resources

The proposal to shift 50 percent of multilateral loans to grants would result in a revenue loss to the World Bank.[8] Since grants reduce the amount of loans made, future repayments would be reduced proportionate to the amount of grants provided. We estimate the present value of total foregone repayments from poor countries to the World Bank to be approximately $9.73 billion over the next 40 years. The total financial loss of the 50-percent grants proposal is approximately $15.6 billion, since the $9.73 billion would have accrued an additional $5.82 billion in investment income to the World Bank. This amount represents about 8 percent of the $120.2 billion in present value terms that the World Bank expects to commit to poor countries over this 40-year time frame. Furthermore, the financial loss of a switch from loans to grants would not begin until the end of the 10-year repayment grace period of IDA loans. At that time, the lost repayments and investment income from the grants proposal would begin to accumulate. Our analysis shows that the present value of foregone revenue of the 50-percent grants proposal would increase from nearly zero after the first 10 years to $2.4 billion after 20 years and then to $15.6 billion after 40 years.

Lost Revenue Unlikely to Be Recouped from IBRD Contributions or Internal Resources

Based on our analysis, the options for making up the foregone revenue from the 50-percent grants proposal are fairly limited. As shown in table 3, the World Bank finances its concessional loan program through International Bank for Reconstruction and Development (IBRD) contributions, internal resources, and donor contributions.

[7]IDA provides concessional financing to the World Bank's poorest member countries.

[8]The financial loss of the 50-percent grants proposal is limited to 40 percent of IDA's future commitments, since grants would only be made available to IDA's poorest members who are not eligible to also borrow from the World Bank's nonconcessional resources.

Table 3: Estimated Sources of IDA Resources for IDA-12, FY 2000-02[a]

Source	Amount (billions of dollars)	Share of total (percent)
IBRD contributions	0.9	4
Internal resources[b]	7.9	39
Donor contributions	11.4	57

[a]Donor countries normally contribute to IDA on 3-year cycles, called replenishments. IDA is currently funded through its 12th replenishment cycle (referred to as IDA-12), which covers fiscal years 2000-02. The next replenishment cycle (IDA-13) is scheduled to commence in fiscal year 2003.

[b]Internal resources are made up of loan repayments (both principal and service charges) and investment income. The World Bank does not separately report the totals of these subcategories.

Source: GAO analysis of World Bank data.

The World Bank would have difficulty substantially increasing revenue from IBRD contributions. IBRD contributions derive from a portion of the profits that the World Bank realizes from loans it makes to middle-income countries. Profits from these loans are primarily used to maintain the World Bank's reserves on middle-income lending, provide contributions to the HIPC initiative, and reduce the interest and fees charged to those countries. Thus, any increase in contributions to IDA from IBRD would come at the expense of those other priorities.

Similarly, the World Bank would have difficulty increasing contributions through its internal resources, which include investment income and loan repayments. Investment income derives from the returns accruing from invested IDA resources that have yet to be disbursed. As of fiscal year 2001, investments were about $11.7 billion, contributing $680 million to IDA. Increased revenue from this source could only be realized by raising the capital stock (for example, by reduced lending), or by increasing the risk of investments (and correspondingly, their expected return) beyond what the World Bank considers prudent.

It would also be unrealistic for the World Bank to significantly increase the amount of income it receives from loan repayments, given the existing debt burdens of many of its poorest members. Increased loan repayments could be accomplished by increasing the interest rate of the loan, shortening the grace period, reducing the repayment period, or some combination of these changes. For example, our analysis found that the current 0-percent interest charge on IDA loans would need to be increased to 2.83 percent for all borrowing countries, to raise sufficient funds to finance the grants

proposal. Changes of this magnitude would represent a doubling of the cost of IDA lending to borrowing countries, effectively nullifying any improvement to their debt sustainability that would accrue from the 50-percent grants proposal.

Small Increases in Donor Contributions Can Make Up the Lost Revenue

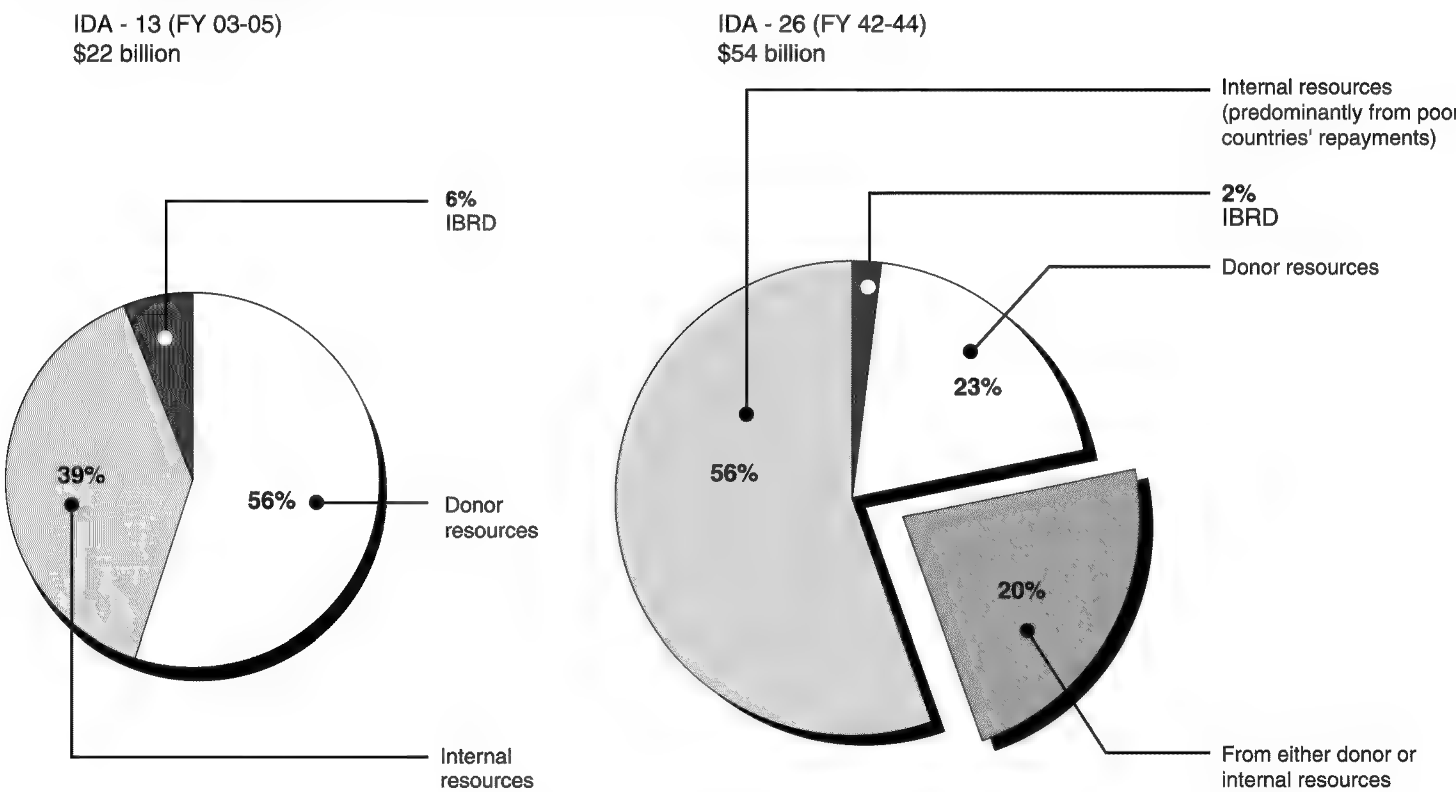
Our analysis shows that the 50-percent grants proposal could be fully financed through small increases in contributions from donor countries over what is currently projected. The amount of repayments required to make up the loss due to grants is estimated to be $9.73 billion in present value terms.[9] If donor countries were to increase their annual contribution to IDA by 1.6 percent over 40 years, the World Bank would receive an additional $9.06 billion in present value terms. Combined with an additional $.67 billion accruing from investment income on the net contributions, the total would fully finance the 50-percent grants proposal. Furthermore, this additional $9.73 billion would itself generate sufficient investment income to erase the remainder of the projected $15.6 billion revenue shortfall. An annual increase in donor contributions of 1.6 percent over the next 40 years would be less than the expected rate of inflation, which is projected to be 2.3 percent over this time period.

The 1.6 percent annual increase would be consistent with donors maintaining their long-term commitment to the IDA program, as indicated by recent discussions among the donors. Donor contributions to IDA are expected to increase by 13.4 percent over the next 3 years, with the U.S. contributions expected to grow by more than 18 percent. However, the World Bank's baseline projections assume that donor involvement with IDA will decline over time. This is because the World Bank assumes that donor and IBRD contributions will stay constant in nominal terms for the next 40 years, while IDA's future lending commitments to poor countries will increase at the annual inflation rate. The long-term implication of these assumptions is that the World Bank projects that future IDA resources will increasingly depend on loan repayments from poor countries to make new loans, as the proportion of IDA resources contributed by donors steadily declines. We consider this an unlikely outcome, especially considering the debt burdens of many of these poor countries. As shown in figure 2, under

[9]The projected financial loss is based on estimates of the impact of the grants proposal on expected loan repayments. This estimate does not include repayments from additional multilateral loans necessary to maintain debt sustainability at historical export growth levels.

World Bank projections, donor resources as a share of future lending commitments will fall from 56 percent during IDA-13 (FY 2003-05) to only 23 percent in IDA-26 (FY 2042-44). However, if donor contributions were to increase by 1.6 percent a year, the donor share would instead rise to 43 percent in IDA-26.

Figure 2: Estimates for the Financing of IDA, FY 2003-05 and FY 2042-44



Note: Internal resources include repayments and investment income. Percentages exceed 100 percent due to rounding.

Source: GAO analysis.

GAO's Projections Differ Substantially from World Bank and IMF Estimates

Our projections on countries' future debt sustainability and the financial loss of the 50-percent grants proposal differ substantially from the estimates of the World Bank and the IMF. While the World Bank and IMF estimate that countries will be debt sustainable under the current debt relief initiative, these projections are based on highly optimistic assumptions about these countries' export growth rates. Furthermore, our characterization of the financial loss of the 50-percent grants proposal differs from the World Bank's because our estimate includes the expected impact of inflation and the investment income that could accrue over time.

GAO Disagrees with World Bank and IMF Projections That the Current Debt Relief Initiative Will Lead to Debt Sustainability

The World Bank and IMF rely on overly optimistic export growth projections to achieve debt sustainability. As shown in table 4, the World Bank and IMF project that the 10 countries we analyzed will all have debt-to-export ratios near or below 150 percent during the 20-year period. To demonstrate debt sustainability, these projections assume that these countries will have very high export growth rates, with rates averaging more than double what they have experienced over the previous 20 years. However, if these countries' exports were to grow at rates consistent with historical levels, only 2 of the 10 countries would be debt sustainable, with 3 countries having debt ratios in excess of 650 percent.

Table 4: Export Growth Rates and Debt/Export Ratios for 10 Poor Countries

Country	World Bank/IMF projected export growth rates (percent)	Projected 20-year debt/export ratios using World Bank/IMF export growth rates (percent)	Historical export growth rates (percent)	Projected 20-year debt/export ratios using historical export growth rates (percent)
Benin	8.1	59	5.2	168
Bolivia	7.1	153	3.1	668
Burkina-Faso	8.7	114	1.8	713
Ethiopia	8.9	79	2.5	572
Mali	5.9	101	6.7	62
Mozambique	7.3	48	4.6	153
Nicaragua	8.5	60	4.1	377
Tanzania	8.9	132	5.1	434
Uganda	9.1	32	3.7	339
Zambia	6.7	101	.5	837
Average	**7.9**	**88**	**3.7**	**432**

Source: GAO analysis.

The World Bank and the IMF assert that under their new approach to development, countries can achieve higher economic growth rates, including export growth, because their emerging development plans will be "country owned," representing buy-ins from both the government and civil society. This country ownership is expected to build a stronger base for the economic and structural reforms needed to enhance productivity. However, we recently reported that achieving this change in approach would be difficult to accomplish. The preparation of these development strategies is complicated, taking a significant amount of time to complete and straining already limited government resources.[10] We also found that civil society ownership of the countries' development priorities is especially difficult to accomplish.

[10]See GAO/NSIAD-00-161 and U.S. General Accounting Office, *International Monetary Fund: Few Changes Evident in Design of New Lending Program for Poor Countries*, GAO-01-581 (Washington, D.C.: May 8, 2001).

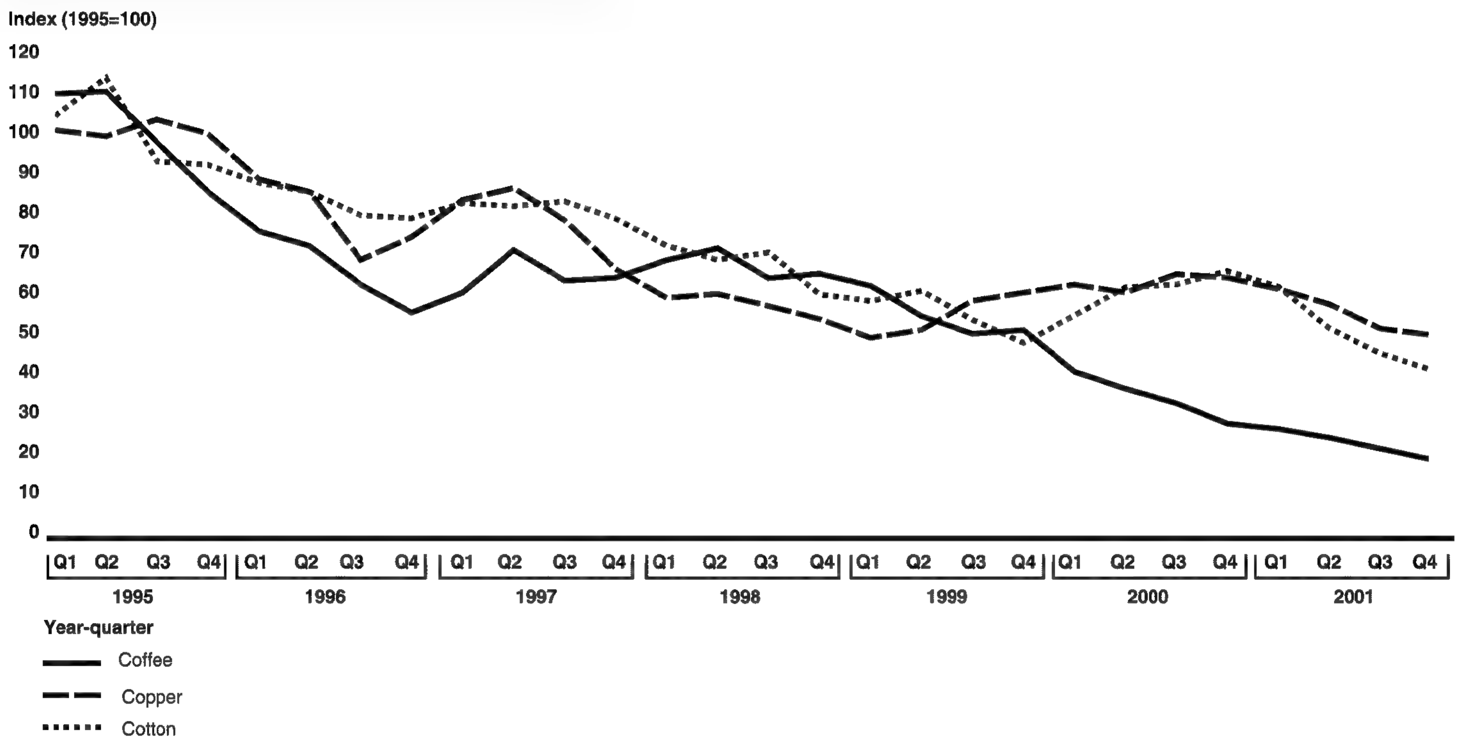
Uncontrollable External Factors Limit Opportunities for Strong Economic Growth

Two key factors make it difficult for poor countries to achieve the high export growth rates assumed by the World Bank and IMF. These factors are the countries' continued reliance on a few primary commodities for much of their export revenue and the growing impact of HIV/AIDS on economic growth. (See app. IV for more detail on the potential vulnerabilities of these poor countries to external shocks.)

Reliance on primary commodities

Most of the 10 countries we analyzed rely on one or two primary agricultural and/or mineral commodities for a significant portion of their foreign exchange earnings. For example, between 1995 and 1997, Zambia relied on copper for 56 percent of its export revenue, and Uganda relied on coffee for 56 percent of its export revenue. The price of these and other commodities has fluctuated over time, usually due to factors outside the control of these countries. As figure 3 shows, the trend in recent years for many of these commodities has been downward, impairing countries' ability to increase their export income. Environmental factors such as floods and drought can also impact export income. For example, Mozambique suffered heavy rains that damaged their agricultural production in 2000, and despite reconstruction efforts, its growth rate in national income fell from 7.5 percent in 1999 to 1.6 percent in 2000.

Figure 3: Cotton, Coffee, and Copper Indexes (1995-2001)



Source: IMF, *International Financial Statistics*, February 2002.

The recent global economic downturn has exacerbated the problem. According to the United Nations, the 2001-02 global recession is expected to have a severe impact on developing countries. The IMF projects that global prices for nonfuel commodities, such as those produced by our case study countries, will fall by 3.8 percentage points between 2000 and 2002. According to the World Bank and the IMF, recovery in the commodities markets may not occur until 2003, provided there are no additional shocks to global markets.

Impact of HIV/AIDS on economic growth

The HIV/AIDS pandemic also serves as a significant restraint on export growth among poor countries. HIV/AIDS is widely recognized by development professionals and multilateral aid organizations as a major threat to the growth rates of many poor countries, because the governments of these countries will need to divert funds from economic growth initiatives to cover dramatically increasing health care costs, rising labor costs, and productivity losses in key export sectors. According to the

World Bank, studies in several sub-Saharan countries have found that the effects of the disease could reduce the rate of economic growth by as much as 25 percent over the next 20 years. In all but 2 of our 10 case-study countries, the rate of HIV/AIDS among adults aged 15 to 49 is above the global average for this age group of 1.07 percent. In Zambia, which has the highest HIV prevalence of our case-study countries, an estimated 19.95 percent of working adults ages 15 to 49 years have HIV or AIDS.

World Bank Estimate of the Financial Loss of the 50-Percent Grants Proposal Overstated

The World Bank has reported that the grants proposal would result in a $100 billion loss to IDA over 40 years, but this estimate does not account for the time value of money. According to the World Bank, about $59 billion of this loss stems from foregone repayments, with the remaining $41 billion derived from foregone interest earnings. The World Bank's methodology assumes that the value of a dollar received today is worth the same as a dollar received 40 years from now. This assumption ignores the impact of inflation or the potential investment income that could accrue over time. In present value terms, the financial loss from the proposal would be $15.6 billion, and $9.73 billion in present value terms would be required to replace the loss.

In contrast to its estimate that the financial loss from the grants proposal will be about $100 billion, the World Bank reported in March 2002 that if donors were to increase their annual contributions to IDA by an average of 2 percent a year, it would fully finance the 50-percent grants proposal. This 2-percent estimate is 25-percent higher than our estimate of an increase of 1.6 percent a year. We identified two reasons that the World Bank estimate differs from ours. First, the World Bank assumes that if donors were to increase their annual contributions to IDA, such contributions would accelerate over time; that is the annual donor increases would be higher in later years than in earlier years. In contrast, we assume the increases in donor contributions would be constant over the entire 40-year period. The advantage of assuming a constant increase is that contributions made in earlier years will have more time to earn investment income, thus lowering the need for future contributions. Second, the World Bank added the cost of fully financing its contribution to the HIPC debt relief initiative within the grants proposal, while excluding the cost of HIPC from its projections of donor contributions without grants. Our analysis excludes the costs of HIPC from both estimates. We believe excluding the costs of HIPC debt relief gives a fairer estimate of the true financial loss of the grants proposal.

Observations

Despite the efforts of the HIPC initiative, our analysis demonstrates that without grants, most of the 10 countries analyzed will experience difficulties repaying their debt. The 50-percent grants proposal substantially lessens the long-term debt burdens of the countries we analyzed and is affordable as long as donors remain committed to financing a significant portion of the IDA program. However, the debt problems of these countries may not be resolved unless the grant component is raised to a level higher than 50 percent across all the multilateral institutions.

Agency Comments

We provided a draft of this report to the secretary of the treasury for review and comment. The Department of the Treasury agrees with the report's primary findings that President Bush's proposal to increase the use of grants at the multilateral development banks is affordable and would lower poor countries' debt burdens more effectively than 100 percent forgiveness of multilateral development bank debt. See appendix V for Treasury's comments.

We are sending copies of this report to appropriate congressional committees and to the Honorable Paul O'Neill, secretary of the treasury. We are also sending copies to the World Bank and the IMF. Copies will be made available to others upon request.

If you or your staff has any questions about this report, please contact me on (202) 512-8979. Another GAO contact and staff acknowledgments are listed in appendix VI.

Joseph A. Christoff

Joseph A. Christoff, Director
International Affairs and Trade

Objectives, Scope, and Methodology

The ranking minority member of the Senate Foreign Relations Committee and the chairman of the House Subcommittee on International Monetary Policy and Trade, Committee on Financial Services, asked us to review the proposal to shift a portion of multilateral institutions' loans for poor countries to grants. In response, we assessed (1) how the loans-to-grants proposal would affect poor countries' ability to repay their debt, (2) how it would affect the resources available to the World Bank for poor countries, and (3) how GAO's projections for countries' debt sustainability and the financial loss to the World Bank from the grants proposal compare with World Bank and International Monetary Fund (IMF) estimates.

We did not discuss our results with the World Bank and the IMF because we were unable to meet with officials from these multilateral institutions in the course of this engagement. GAO has an agreement with the IMF, World Bank, the Department of the Treasury, and the U.S. Executive Directors at the IMF and the World Bank that Treasury must approve our access to officials of those institutions.[11] For this engagement, Treasury officials denied our requests for access to officials of the multilateral institutions because they were concerned that our engagement would interfere with ongoing negotiations to refinance the World Bank's International Development Agency.

To assess how the loans-to-grants proposal would affect poor countries' ability to repay their debt, we built on prior work that examined the World Bank and IMF's debt sustainability model, including their export growth projections. The World Bank and the IMF reviewed and provided detailed comments on that earlier analysis. We supplemented this work with additional data from the IMF and the World Bank. First, we examined the World Bank's and IMF's debt sustainability analyses for 10 of the 27 countries in the Heavily Indebted Poor Countries (HIPC) initiative that have reached a decision point—Benin, Bolivia, Burkina Faso, Ethiopia, Mali, Mozambique, Nicaragua, Tanzania, Uganda, and Zambia.[12] These countries are geographically dispersed, represent a wide range of

[11]The articles of agreement establishing the World Bank and the IMF require the United States to deal with these organizations only through the Department of the Treasury.

[12]Under the current debt relief initiative, countries seeking debt relief must first carry out economic and social reforms under specified programs, at which point their eligibility is assessed at what is called the "decision point." The World Bank and IMF then determine what assistance is required to maintain debt sustainability and prepare detailed analyses for this purpose.

economic conditions, and receive about two-thirds of internationally-provided debt relief. Our evaluation of the World Bank and IMF analyses focused on projections for key economic variables including debt stock, debt service, donor assistance, and exports.[13] Second, we projected these countries' debt ratios over a 20-year period, examining the impact of both historic export growth rates and the 50-percent grants proposal on countries' debt sustainability.[14] Third, we calculated the impact of both historic export growth rates and the 50-percent grants proposal on multilateral receipts and required donor assistance. Finally, we compared the effect of the grants proposal in promoting debt sustainability to other proposals calling for forgiveness of all old multilateral debt.

To assess how the loans to grants proposal would affect the resources available to the World Bank for poor countries, we analyzed the implications of a shift to grants on the World Bank's medium-and long-term cash flows. We did so by applying the same assumptions used by the World Bank in its financial projections model (see app. III for more detail on these assumptions). Specifically, we analyzed how much revenue would be forgone by the World Bank over a 40-year period as the flow of repayments of loans diminished over time, in both nominal and present value terms. We then analyzed several options to make up the shortfall in repayments over the 40-year period through both internal and external resources available to the World Bank. These included making the terms of remaining loans harder, such as decreasing the period for repayment or raising the interest rate. We also analyzed the effect of increasing donor contributions over their current levels by calculating the average percent increase in donor contributions necessary to offset the forgone resources.

For our third objective, we first compared how GAO's projections for countries' debt sustainability differ from World Bank and IMF estimates. Our analysis of country-specific economic conditions was primarily based on information from *IMF/World Bank Decision-Point Documents*, *World Bank/IMF Poverty Reduction Strategy Papers*, *Interim Poverty Reduction*

[13]In some cases, we replaced gaps in data through interpolation.

[14]To estimate the effects of lower export growth rates, we replaced the annual shortfall in foreign exchange earnings with increased donor assistance in the same annual proportions of grants and concessional loans as indicated in each country's debt sustainability analysis. We assumed that these additional loans were provided at the same level of concessionality as IDA—40-year maturity, 10-year grace period, 0-percent interest and 0.75 percent service charge.

Strategy Papers, the CIA *World Fact Book (2001)*, and other case-study papers by the IMF and the World Bank. In addition, the primary sources of data pertaining to price fluctuations of commodities and export data were IMF financial statistics and the United Nations Statistics Division COMTRADE database. With regard to HIV/AIDS and its impact on economic development, data came from the above sources, plus reports obtained from the Joint United Nations Programme on HIV/AIDS, reports prepared directly by or under contract to the World Bank and IMF, and reports by the World Health Organization. Finally, we prepared a direct comparison of GAO's projections for the financial impact of the grants proposal to World Bank and IMF estimates.

We conducted our work from September 2001 through April 2002 in accordance with generally accepted government auditing standards.

Economic Assumptions Used to Analyze Debt Sustainability

World Bank and IMF 20-year Economic Projections Provided Basis for Analysis

Once a country is deemed eligible to enter the HIPC initiative, World Bank and IMF staff prepare a debt sustainability analysis (DSA). The DSA details 20-year economic projections for a country's exports, national income, government revenue, debt stock, debt service, foreign assistance, and other economic indicators. The analysis also discusses the amount of debt relief the country must receive to become debt sustainable and how this debt relief would be distributed among creditors. World Bank and IMF projections for these variables provided GAO with the basis for assessing the impact of changing key assumptions, including substituting 50 percent of future multilateral lending with grants.

Impact of Using Historical Export Growth Rates

As discussed in the report, the World Bank and IMF DSAs assume that HIPC countries' future export growth rates, on average, will be more than double historical levels.[15] An approach consistent with the historical record is more conservative. Therefore, to evaluate the impact of this conservative approach, we replaced the World Bank and IMF export growth rates with each country's historical export growth rate over the previous 20 years, while maintaining all the other assumptions implicit in the DSA. We refer to this as the historical baseline.

Under the historical baseline, most countries are expected to experience shortfalls in their balance of payments revenue as exports grow slower than World Bank and IMF projections. Since these countries are assumed within the DSAs to follow their development programs,[16] including achieving the growth rates necessary to reach their 2015 development goals, any shortfalls in their export growth are assumed to be due to factors outside of their control. Accordingly, we assumed that, for these countries to achieve the gross domestic product (GDP) growth rate projected in their DSAs, they will have to receive increased bilateral and multilateral economic assistance to close this emerging balance of payments deficit. The total assistance required to erase the deficit for the 10 countries analyzed more than doubles during the 20-year projection period, from $73.5 billion in present value under the World Bank and IMF export

[15]Average export growth rates (both projected and historical) are the average annualized growth rates calculated using ordinary least squares regression.

[16]Countries are expected, for example, to achieve their goals of good governance, anticorruption, transparent budget processes, and poverty reduction as described in each country's poverty reduction strategy papers.

assumptions to $153.2 billion, using the historical baseline. We also assume that this new assistance will be in the form of both loans and grants, with the annual proportions equivalent to those embedded within each country's DSA baseline projections.[17] Closing the balance of payments deficits allows each of the 10 countries to continue to achieve the same GDP growth rates as projected by the World Bank and IMF. If these countries do not receive the necessary additional financing, then economic growth, income, and imports would decline to close the balance of payments deficit. While this economic contraction would somewhat lessen the countries' future debt burdens, it could also adversely affect their progress in reducing poverty.

Impact of 100-percent Forgiveness of Old Multilateral Debt

To analyze the impact of 100-percent cancellation of old multilateral debt, we reduced the debt of the 10 countries by their total stock of existing multilateral debt. We made this adjustment as of the beginning of the 20-year projection period, coinciding with these countries' receipt of HIPC debt relief. While substantial, this debt stock reduction does not entirely eliminate the debt burdens of these countries because the countries retain the portion of their pre-existing bilateral debt that was not included under the HIPC program. Although HIPC reduces bilateral debt substantially, debt that accrued after the date that countries first received debt relief under the Paris Club process is not considered eligible for debt relief.[18] Under the historical exports scenario, the average debt-to-export ratio for the 10 countries declines from the initial value of 161 percent before the elimination of their multilateral debt stock to 78 percent afterward. However, due to the steady accumulation of a substantial amount of new debt, the average debt-to-export ratio for the 10 countries rises to 402 by the end of the 20-year projection period, nearly as high as the projected

[17]The DSA baseline assumes that most of the future bilateral assistance received by these countries will be in the form of grants, while multilateral assistance is in the form of loans.

[18]The Paris Club is an informal group of bilateral creditors that meets, on an as-needed basis, to negotiate debt relief on sovereign debt. Over the past 14 years, the Paris Club has undertaken actions to reduce or cancel public debt owed to them by heavily indebted poor countries. Prior to 1988, the Paris Club generally engaged in rescheduling, but not reducing, debt. This solved immediate debt-servicing crises but offered no permanent relief. The Paris Club generally limits the debt that is eligible to be rescheduled to market-based debt, such as loans to support exports from the lending country and loans that were incurred before an agreed-upon cutoff date. This date corresponds to the first time that a country requests debt rescheduling/relief from the Paris Club. For many potential HIPC recipients, this date occurred in the 1980s, and thus eligible debt was contracted before this time.

debt ratio under the historical baseline with no multilateral debt forgiveness (432).

Assumptions Used to Analyze the Financial Impact of the 50-Percent Grants Proposal on the World Bank

World Bank's Assumptions Key in Its Projection of Large Financial Losses

To analyze the financial impact of the 50-percent grants proposal, we relied on World Bank documents that listed the assumptions the World Bank used to make its projections and the details of those projections. As discussed in appendix 1, GAO did not have access to World Bank staff on this assignment. Therefore, our approach was to use information in the World Bank's documents to duplicate the World Bank's own projections and analyze the implications of changing some of the World Bank's underlying assumptions.

In projecting the financial impact of the 50-percent grants proposal, the World Bank used two sets of assumptions: core assumptions for the International Development Agency's (IDA) financial situation, and assumptions relevant to the 50-percent grants proposal (see table 5). The World Bank's projections take into account all of IDA's expected cash inflows (donor contributions, principal repayments, service charges, investment income, and International Bank for Reconstruction and Development [IBRD] contributions from its net income) and cash outflows (disbursements of assistance, administrative expenses, and HIPC debt relief payments).

Table 5: Assumptions Used by the World Bank for Its IDA Financial Projections

Core assumptions used in financial projections model	Additional assumptions used to analyze IDA's financial projections when grants are included
• Future IDA assistance program remains level in real terms. • Donor contributions remain level in nominal terms. • Donor encashments match disbursements. • Loan and grant disbursement profiles are based on a projected mix of investment and programmatic assistance. • Future nominal investment income is based on expected returns of 5 percent per year. • Principal repayments assume a 5-percent noncollection rate, based on historic pattern. • IBRD net income transfers to IDA remain level in nominal terms at $300 million per year. • No change in IDA lending terms (0.75 percent service charge on net disbursements, no loan commitment fee). • Costs of HIPC debt service forgiveness are fully covered by IBRD net income pledge and subsequently by additional donor contributions. • IDA's share of the World Bank's administrative expenses remains level in real terms. • IDA is broadly immunized against currency risk.	• IDA-only countries account for 80 percent of IDA assistance. • Grants are provided to IDA-only countries. (50 percent grants means 40 percent of total IDA assistance are grants.) • Lending terms for IDA-only are 10-year grace period and 40-year maturity. • Lending terms for "blend" countries are 10-year grace period and 35-year maturity. • Grants have a 0.5 percent annual commitment charge that will be paid as a flat fee for 6 years. • Future inflation rate is 2.3 percent per year. • The discount rate over the 40-year period is 6.3 percent. • Programmatic adjustment lending represents 30 percent of IDA assistance for IDA-13 and 35 percent for subsequent years.

Source: World Bank, *IDA Funding Scheme and Financial Projections, 2001.*

We found that two of the World Bank's core assumptions were critical in generating the Bank's projected $100 billion loss over 40 years due to the 50-percent grants proposal. First, the World Bank assumes projected future lending will grow at the rate of inflation. Second, the World Bank assumes donor contributions will remain fixed in nominal terms. The assumption that IDA lending will increase at the annual inflation rate is reasonably consistent with the World Bank's recent experience. Over the last decade (FY 1991-2001), the World Bank estimates that IDA lending grew at an annual rate of about 4 percent, while the U.S. inflation rate was somewhat less than 3 percent annually over the same period. Similarly, the assumption that donor resources will remain constant in nominal terms is close to the World Bank's experience over the last 10 years. During this period, donor replenishment contributions rose from $12.4 billion (IDA-8 FY 1988-90) to $18.0 billion (IDA-10 FY 1994-96) and then declined to $11.6 billion (IDA-12 FY 2000-02).

However, taken together, the long-term implication of these two assumptions is that donor resources as a percentage of total commitments are projected to steadily decline over time, falling from 56 percent of lending commitments during IDA-13, to only 23 percent during FY 2042-44 (IDA-26). To compensate for a reduction in donor resources, the World Bank assumes that internally generated resources, especially loan repayments, will grow over time. The assumption that future lending will be increasingly dependent on loan repayments greatly increases the financial impact of the 50-percent grants proposal. Since the poorest countries are projected to receive 80 percent of all IDA assistance and account for 80 percent of all future repayments, the 50-percent grants proposal would reduce IDA internally generated resources by about 40 percent.

Harder Loan Terms on Borrowing Countries Is an Unrealistic Option for Replacing Foregone Revenues due to Grants

We found that it would be unrealistic for the World Bank to significantly increase the amount of income it receives from loan repayments, given the existing debt burdens of many of its poorest members. Lending under the IDA program is considered "concessional" in that its loan terms are considerably softer than market-based terms. The World Bank estimates that loans under IDA have a "grant element" of 64 percent. That is, from the perspective of recipient countries, a $1 million IDA loan is equivalent to receiving the combination of a grant worth $640,000 and a market-based loan of $360,000. Our analysis shows that to finance the 50-percent grants proposal through a hardening of IDA loan terms, the grant element of the remaining loans would have to be reduced to 32 percent.

Table 6: Examples of Harder Loan Terms on IDA Countries to Finance 50-Percent Grants Proposal

	Current IDA terms	Option 1	Option 2	Option 3	Option 4	Option 5
Interest rate	0%	2.83%	2.0%	2.2%	1%	0%
Grace period, years	10	10	10	5	5	5
Maturity, years	40	40	18	30	15	11
Service charge	0.75%	0.75%	0.75%	0.75%	0.75%	0.75%
Total charges	0.75%	3.58%	2.75%	2.95%	1.75%	0.75%
Grant element	64%	32%	32%	32%	32%	32%

Note: For each option we assume equal annual principal repayments after the grace period.

Source: GAO analysis.

The reduction in the grant element could be accomplished by hardening loan terms several ways: by increasing the interest rate of the loan, shortening the grace period, reducing the repayment period, or some combination of these changes. For example, the current 0-percent interest charge on IDA loans could be increased to 2.83 percent, resulting in a total annual charge of 3.58 percent (see table 6). Alternatively, the grace period could be reduced to 5 years, with a total maturity of 11 years. However, changes of this magnitude to the grant element would represent almost a doubling of the cost of IDA lending to borrowing countries and effectively nullify any improvements to their debt sustainability that would accrue from the 50-percent grants proposal.

Optimistic Export Growth Assumptions Underlie World Bank/IMF Debt Sustainability Analysis

World Bank/IMF Projected Export Growth Rates Greatly Exceed Historical Levels

The World Bank and IMF project that the average annual export growth rate for the 10 countries we analyzed to be 7.9 percent over the next 20 years (see table 7). However, the historical export growth rate over the past 20 years for these 10 countries—3.7 percent annually—is less than half that amount. Similarly, for the 27 countries for which data were available, the World Bank/IMF projects that the average annual export growth rate will be 7.4 percent, compared to the historical average of 3.3 percent annually. A comparison of the World Bank/IMF projections with the historical values for individual countries reveals some important features. The World Bank/IMF projected export growth rates for 4 of the 27 countries (Chad, The Gambia, Guyana, and Mali) are lower than their historical levels and thus may not require any grants to replace future lending to attain debt sustainability. Alternatively, 5 countries have 20-year historical export growth rates of zero or less (Cameroon, Niger, Rwanda, Sao Tome & Principe, and Sierra Leone) and may not be able to attain debt sustainability with less than 100-percent grants.

Table 7: 20-Year Historical and DSA Export Growth Rates for 27 HIPCs

27 HIPC countries	Historical export growth rate, 1980-1999 (percent)	World Bank/IMF export growth rate projections, 2001-2020 (percent)
Benin[a]	5.2	8.1
Bolivia[a]	3.1	7.1
Burkina Faso[a]	1.8	8.7
Cameroon	0.0	6.7
Chad	9.0	5.6
Cote d'Ivoire	3.1	7.2
Ethiopia[a]	2.5	8.9
The Gambia	8.3	5.9
Ghana	6.7	6.8
Guinea	2.1	7.1
Guinea-Bissau	7.1	9.2
Guyana"	7.1	4.1
Honduras	6.4	9.5
Madagascar	4.9	8.0
Malawi	4.4	4.9

(Continued From Previous Page)

27 HIPC countries	Historical export growth rate, 1980-1999 (percent)	World Bank/IMF export growth rate projections, 2001-2020 (percent)
Mali[a]	6.7	5.9
Mauritania	1.9	5.9
Mozambique[a]	4.6	7.3
Nicaragua[a]	4.1	8.5
Niger	-2.5	7.6
Rwanda	-4.2	10.5
Sao Tome & Principe	-1.7	6.9
Senegal	3.0	6.3
Sierra Leone	-3.7	7.0
Tanzania[ab]	5.1	8.9
Uganda[a]	3.7	9.1
Zambia[a]	0.5	6.7
Average – 10 countries analyzed	**3.7**	**7.9**
Average – All 27 countries	**3.3**	**7.4**

[a]Included in our analysis of 10 countries.

[b]Historical GDP is from 1988-1999.

Source: Data on historical exports of goods and services from the World Bank Global Development Finance 2001 CD-ROM, series (XGS) (US$), 1980-1999. DSA export growth rate data from GAO analysis of *IMF/World Bank Decision-Point Documents* for HIPC countries.

Continued Reliance on Primary Commodities Limits Export Growth

The 10 countries in our study face increased economic risk because they rely heavily on only a few primary agricultural and/or mineral commodities for a significant amount of their foreign exchange earnings (see table 8).

Table 8: Primary and Secondary Commodity Exports

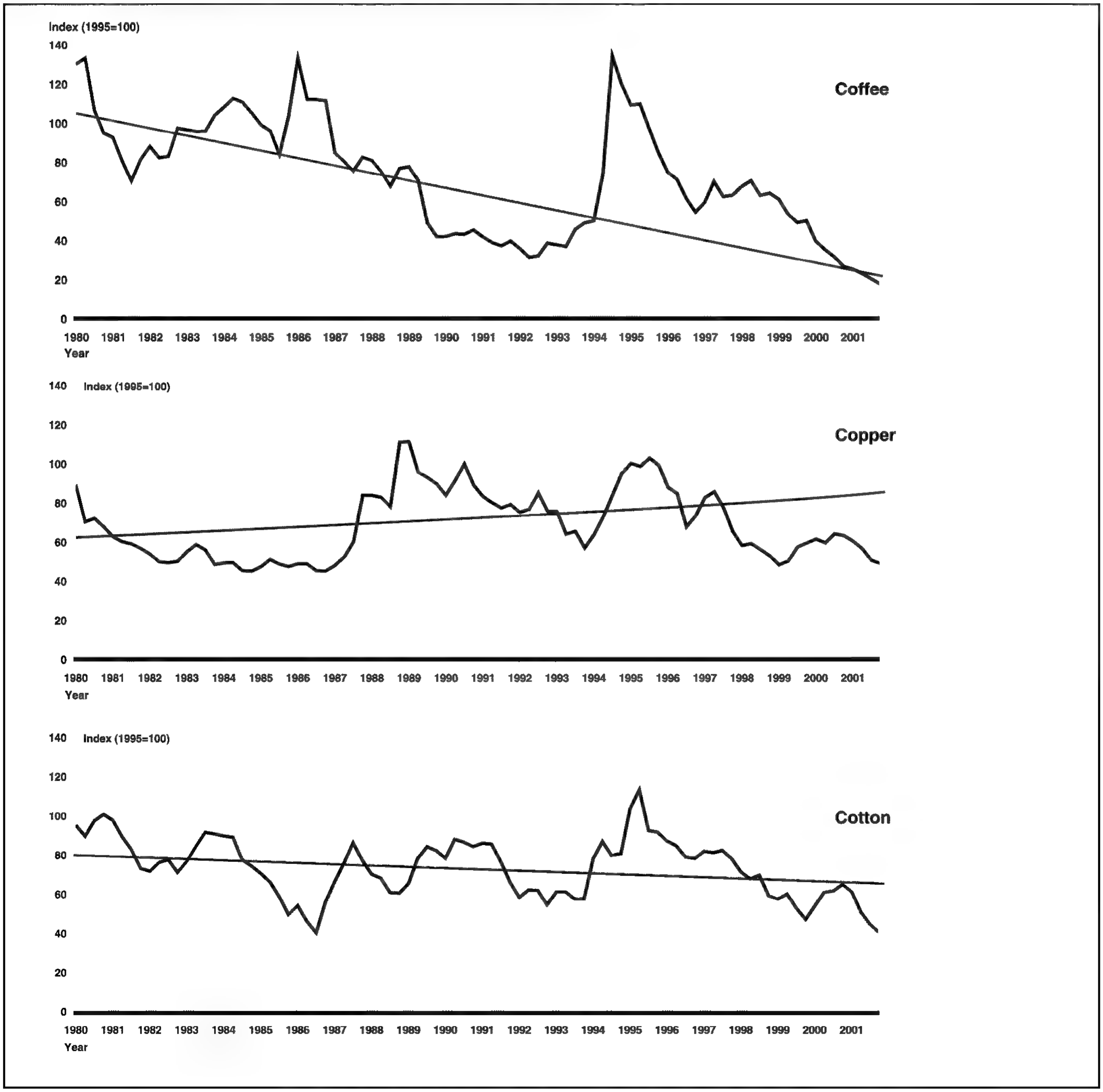
	Primary commodity	Secondary commodities
Benin	Cotton	Palm products Fruit/nuts Tobacco Crude Oil
Bolivia	Zinc	Soybean Products Hydrocarbons/natural gas Gold Silver
Burkina Faso	Cotton	Livestock/meat Gold Leather/hides
Ethiopia	Coffee	Vegetable products Leather Palm products Gold
Mali	Cotton	Gold Livestock
Mozambique	Shellfish	Electricity Cashews Cotton
Nicaragua	Coffee	Shellfish Sugar Meat
Tanzania	Coffee	Cashews Fish Tobacco Cotton Tea
Uganda	Coffee	Gold Fish/fish products Tobacco Cotton Tea
Zambia	Copper	Cobalt Tobacco Electricity

Source: Data for all but 2 countries are from the United Nations *HS Merchandise Trade Statistics* (1997-2000, latest available). Data for Burkina Faso and Zambia are from the World Bank "Country-at-a-Glance" (2001) and the CIA *World Fact Book (2001*).

Global prices for commodities can fluctuate from year to year and thus diminish the ability to accurately predict export earnings and growth rates. Global price fluctuations or a regional environmental shock, such as flood

or drought, could cause export earnings to decline. Figure 4 shows the historical volatility of coffee, cotton, and copper—three commodities important to the 10 countries we analyzed.

Figure 4: Global Indexes for Cotton, Copper, and Coffee, 1980-2001



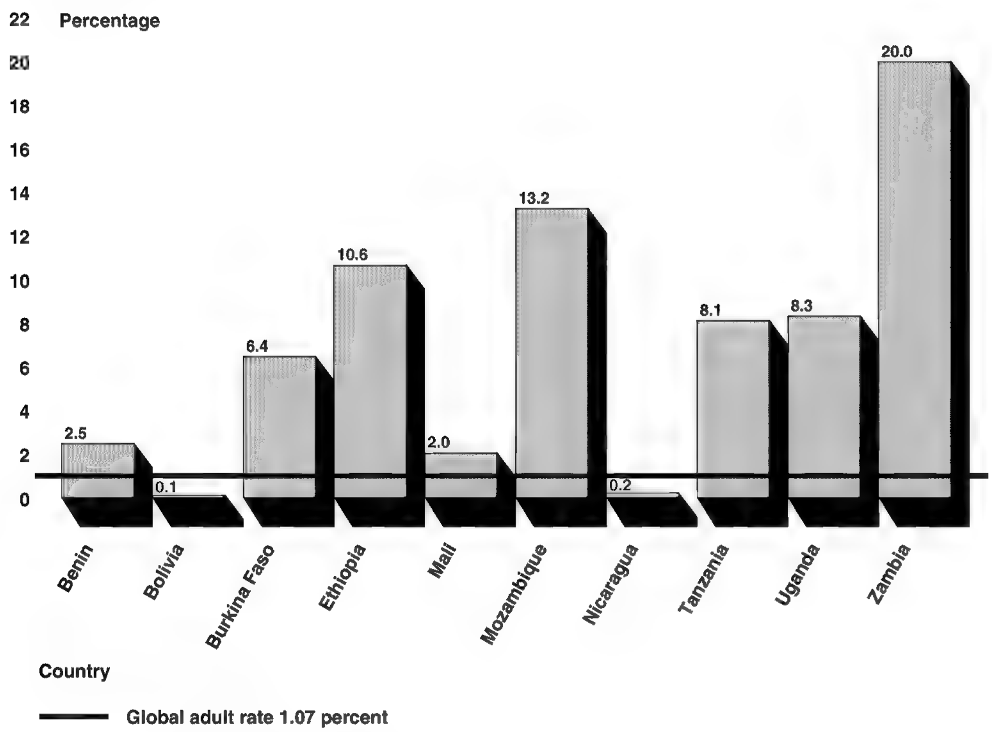
Source: IMF, *International Financial Statistics*, February 2002.

The 20-year price trend for cotton and coffee has been downward, and the trend for all three commodities has been downward over the last 6 years. The volatility and negative trends in the prices of these commodities will make it difficult for many countries to realize large increases in export revenue growth. Zambia, for example, is heavily dependent on export earnings from copper and other metals. The IMF anticipates the export growth rate for Zambia to be 6.7 percent per year over the next 20 years. Historically, however, Zambia's growth rate has averaged 0.53 percent per year over the last 20 years. Despite recognition of the volatility of copper, the IMF anticipated optimistic export projections for Zambia—in part due to the privatization of Zambia Consolidated Copper Mines, the primary state-owned copper producer. However, the recent slump in copper prices, coupled with the withdrawal of the primary foreign investor in this operation, in January 2002, have adversely affected Zambia's copper mining. The long-term prospects for the copper industry in Zambia remain uncertain.

HIV/AIDS Expected to Have a Significant Long-term Negative Impact

Development professionals and multilateral aid organizations widely recognize that the HIV/AIDS pandemic is a major threat to the growth rates of many affected countries. The average global percentage among adults aged 15-49 living with HIV/AIDS is 1.07 percent. However, conditions appear to be worsening in most of our case study countries. According to an IMF report referring to research done in southern Africa, once the rate of HIV prevalence exceeds 5 percent (as it has in 6 of our 10 case study countries), it soars rapidly (see figure 5).

Figure 5: Adult Prevalence of HIV/AIDS among Adults Aged 15-49, 2000



Source: UNAIDS.

The increasing prevalence of HIV/AIDS raises several challenges for many HIPC nations. According to the IMF and World Bank, HIV/AIDS will have substantial effects on a broad range of economic variables, including GDP growth, poverty and income inequality, labor supply, domestic savings, and productivity. AIDS primarily affects people in the most productive age group (ages 15 to 49). On a household level, families may face a loss of income at the same time other expenses, such as health care, are rising. Producers' labor costs rise and productivity declines as a result of HIV/AIDS. The disease is especially problematic for the agricultural and mining sectors, which are critical for achieving export growth. On a national scale, governments are forced to divert funds from economic growth initiatives to cover dramatically rising health care costs and higher public sector pension fund expenditures.

Comments from the Department of the Treasury

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

April 15, 2002

VIA FACSIMILE: (202) 512-9088

Mr. Joseph A. Christoff
Director
International Affairs and Trade
U.S. General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Christoff:

Thank you for the opportunity to comment on the General Accounting Office's (GAO) draft report on President Bush's grants proposal and its cost implications for the International Development Association (IDA). The report (Developing Countries: Switching Some Multilateral Loans to Grants lessons Poor Country Debt Burdens; GAO/02-593) covers a particularly important and challenging subject in a constructive way. Treasury agrees with the conclusions. Following are more detailed comments on the report.

Report Conclusions – Treasury agrees with the report's primary conclusions: that President Bush's proposal to increase the use of grants at the multilateral development banks is affordable and would lower poor countries' debt burdens more effectively than 100 percent forgiveness of multilateral development bank debt. The analysis clearly presents information which should convince other donors to support President Bush's proposal.

GAO Access to the International Financial Institutions (IFIs) – The report accurately reflects Treasury's request that GAO not consult or discuss with IFI staff issues related to this report because of concern that such access could interfere with international negotiations for IDA-13. The report should highlight that Treasury provided GAO access to all key documents to which Treasury itself had access.

Commodity Prices – The report provided a very useful discussion of the trends in commodity prices. Treasury agrees that reliance on overly optimistic assumptions for the future growth of such export commodities is imprudent, particularly given the recent trend. The declining trends in commodity prices and the reliance on such prices by the poorest countries for their export earnings provide one of the strongest justifications for President Bush's grants proposal. In that respect, layering additional debt on the poorest countries under the assumption that HIPC debt levels are now "sustainable" is overly optimistic in assuming that external conditions will be highly positive for these countries over the next 20 years. Having the multilateral development banks provide grants recognizes the fragility of these countries'

economic circumstances and provides a rational and long-term approach to delivering development assistance.

Future Donor Resources – Treasury agrees with the report's conclusion that it is unlikely that the proportion of IDA resources contributed by donors steadily declines. The explicit expectation under such circumstances is that the poorest countries will finance new IDA replenishments through their repayments on old loans. Reliance on reflows from IDA borrowing countries is akin to saying that the prime responsibility for funding the development needs of the poor should be borne by the poor countries themselves. It may be useful to note that even if the full U.S. grants proposal ran for 40 years, donor money and loan repayments would provide roughly the same share of financing for future IDA replenishments that they provide today.

HIPC Debt Sustainability – The report should clarify that a net present value of debt to exports ratio of 150 percent is not an agreed definition of debt sustainability. The enhanced HIPC initiative established the 150 percent ratio as a target at Decision Point, compared to the target of 200 to 250 percent at the Completion Point under the initial HIPC program, to provide a financial cushion given the vulnerability of these countries. The report should also make clear that projections of debt ratios going out over 20 years are heavily dependent on export growth assumptions. GAO uses average 1980-99 export growth rates in this report, which are less than half the Bank/Fund projected levels. Treasury agrees with conclusions in GAO's prior report that Bank/Fund projections are likely too optimistic. It also agrees with GAO's acknowledgment in the same report that those growth levels are generally consistent with export growth levels in the recent past.

One final point should be noted. The World Bank has been fully cooperative throughout the IDA-13 negotiations in responding to donor requests for cost estimates concerning the IDA grants issue and has been clear concerning the underlying assumptions supporting those estimates.

The Treasury Department is committed to promoting new ideas to make development more effective. Treasury appreciates GAO's continuing constructive role in overseeing the IFIs. Thank you for the opportunity to comment on this report.

Sincerely,

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